2012

Recent Tax Developments in Virginia: 2011-2012

William L.S Rowe

Craig D. Bell

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William L. S. Rowe
Hunton & Williams LLP
951 East Byrd Street
Richmond, Virginia 23219
wrowe@hunton.com
Telephone: (804) 788-8410
Facsimile: (804) 788-8218

Craig D. Bell
McGuireWoods LLP
901 East Cary Street
Richmond, Virginia 23219
cdbell@mcguirewoods.com
Telephone: (804) 775-1179
Facsimile: (804) 698-2160

I. CORPORATE INCOME TAX[1]

A. Legislation

1. Single Sales Factor. Virginia adopts single sales factor apportionment for retail merchants and Manufacturers, but does so in very different ways. Both methods phase in the effects of SSF between 2012 and July 1, 2015.

   Retail Merchants. Virginia Code § 58.1-408 provides for mandatory SSF by "retail companies" which is defined by reference to Sectors 44 - 45 of the NAICS.

   Manufacturers. The use of SSF by manufacturers continues to be optional. Any manufacturer who elects SSF must maintain its employment levels at 90% of the year preceding the election and pay its workers more than the average weekly wage of the industry. Failure to meet both standards results in a claw back of tax benefits, with interest but without penalty.

2. Conformity. Virginia's conformity with federal law is advanced to December 31, 2011.

B. Cases

1. *Albert J. Starnes v. Commissioner*, T.C. Memo 2011-63 (2011), aff'd *Starnes v. Commissioner*, 680 F.3d 417 (4th Cir. 2012). Tarcon, a North Carolina business, had discontinued most of its operations and sold its real estate generating tax gains inside the corporation. At this point, Tarcon held only cash. It was solicited to sell the company's stock for an amount

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[1] The summaries in this outline are intended to alert the read to certain developments in Virginia law. Not all developments are reviewed. Readers should refer to the actual legislation, ruling, etc. for a complete and correct understanding of the development.

equal to a percent of its cash. The net result was more after tax cash to the shareholders than if they had liquidated Tarcon, paying the corporate tax, and then paying tax on the liquidation. Unknown to the former shareholders, the new owners of Tarcon engaged in an abusive tax shelter transaction that generated fictitious losses to offset the gains from the sale of Tarcon's real estate. Based on its position in IRS Notice 2001-16, 2001-1 C.B. 730, the IRS recharacterized the transaction as a liquidation of Tarcon followed by distributions to its shareholders resulting in substantial tax, interest, and penalties owed by Tarcon which no longer existed. When the new owners of Tarcon failed to pay Tarcon's tax liabilities, the IRS asserted the tax against the former shareholders under a transferee liability theory. Judge Cohen for the Tax Court held for the taxpayers that they could not be held responsible as transferees. Following *Commissioner v. Stern*, 357 U. S. 39 (1958), Judge Cohen held that transferee liability must be determined under state law. By her analysis, there was no transferee liability under North Carolina law because the shareholders lacked any knowledge of the purchasers' tax shelter plans. On appeal to the Fourth Circuit, the IRS' position is that it can look to federal law to recharacterize the transaction and apply that recast of the facts to obtain transferee liability under state law.

In a series of cases involving similar fact patterns to *Starnes*, the IRS has lost all but one of the cases it has brought against former shareholders in the Tax Court. In general, the result in those cases turned on whether the former shareholders had knowledge of the buyer's tax abuse. *Salus Mundi Foundation v. Commissioner of Internal Revenue*, T.C. Memo. 2012-61 (IRS did not prove shareholders had knowledge of buyer's plans; transferee liability not imposed); *Slone v. Comm'r*, T.C. Memo. 2012-57 (same); *Frank Sawyer Trust of May 1992 v. Commissioner of Internal Revenue*, T.C. Memo. 2011-298 (same); *Feldman v. Commissioner of Internal Revenue*, T.C. Memo. 2011-297 (shareholders knew about buyer's plans; transferee liability imposed); *Shockley v. Commissioner of Internal Revenue*, T.C. Memo. 2011-63 (IRS did not issue transferee notice within statute of limitations; transferee liability not imposed); *Griffin v. Commissioner of Internal Revenue*, T.C. Memo. 2011-61 (Tax Court determines transaction cannot be recast as an asset sale followed by distribution under federal income tax principles; transferee liability not imposed); *Diebold v. Commissioner of Internal Revenue*, T.C. Memo. 2010-238 (Tax Court determines IRS pursued wrong taxpayer; transferee liability not imposed); *LR Dev. Co., LLC v. Commissioner*, T.C. Memo. 2010-203 (IRS did not prove elements for imposing transferee liability under state law; transferee liability not imposed).

2. *Wendy's International Inc. v. Virginia Department of Taxation*, Cir. Ct. City of Richmond Case No. CL 09-3757 (March 29, 2012), *petition for appeal filed*. Certain trademarks and other intangibles were licensed by

Oldemark LLC, a related entity, to Wendy's International for a royalty equal to 3% of gross revenues. Wendy's, in turn, licensed its own intangibles and sublicensed the Oldemark intangibles for a total royalty of 4%. Approximately two-thirds of the royalties received by Wendy's International were from unrelated franchisees. Department of Taxation argued that the "safe harbor" applicable when an intangible holding company "derives" more than one-third of its revenues from unrelated parties and licenses those intangibles to related parties on the same terms, did not apply. According to the Department, only direct licensing arrangements were covered by the safe harbor. The trial court disagreed with the Department, holding that the statute was clear and unambiguous in providing a safe harbor when more than one-third of royalties "derived" from unrelated parties. The term "derived" does not connote any direct licensing relationship.

C. Rulings of the State Tax Commissioner

1. Nexus/Factors. PD 11-139 (August 2, 2011). Out-of-state engineering firm was erroneously included in the Virginia consolidated return of the affiliated group. Engineering firm had no property or sales in Virginia. Its only payroll was two Virginia employees who worked at the company's office in another state. Because the taxpayer had no factors in Virginia, it had no nexus with Virginia.

2. Virginia Corporation/Nexus. PD 11-199 (December 9, 2011). Even though incorporated under Virginia law and therefore required to file a Virginia return, a corporation is not subject to Virginia income tax unless it has nexus with Virginia. This requires positive apportionment factors. Subsidiaries in question may have had connections with Virginia, but they did not have positive apportionment factors and therefore did not have nexus. They could not be included in the consolidated Virginia return.

3. Nexus/Internet Servers. PD 12-36 (March 28, 2012). Corporation had salesmen in Virginia soliciting sales of Internet services which were provided from out of state except for the presence in Virginia of servers to which the corporation had no physical access. Commissioner holds that presence of servers exceeds protection provided by PL 86-272. Following the *General Motors* case, income from services can be apportioned based on either total costs or direct costs only (per regulation). If the greater proportion of services are performed outside Virginia, then none of the sales produced by those services is apportionable to Virginia.

4. Virginia Source Income. PD 12-138 (August 28, 2012). Law firm had an administrative office in Virginia, but all of its lawyers were located in an adjoining state and were authorized to practice only in that state. Commissioner holds that this S corp does have income from Virginia sources based on the fact that it has both property and payroll here.

Whether it has sales taxable in Virginia will depend upon the predominate location of the costs of performance.

5. Destination Sales. PD 12-142 (August 29, 2012). Manufacturer with its sole plant and headquarters in Virginia could nevertheless apportion sales if it could establish that its activities in a foreign country in installing goods it sells would exceed the protections of PL 86-272. If the seller knew that the ultimate destination of the property it was shipping was outside Virginia, it was not a Virginia sale. By contrast, if the equipment was held in a Virginia warehouse, with shipping directed and controlled by the purchaser, this would be deemed a Virginia sale, not an out of state sale.

6. Construction Contract Apportionment. PD 12-47 (April 23, 2012). Contractor, which apportioned using the three-factor method, performed contracts in Maryland using Virginia based employees. In determining "costs of performance" for purposes of the sales factor, taxpayer must determine if direct costs associated with contracts performed outside of Virginia exceed such costs incurred within Virginia. Although the Department generally looks to whether wages are reported to the VEC as controlling whether those wages are in the Virginia numerator, because of the reciprocity between Maryland and Virginia, tax payer can demonstrate the wages actually paid to workers outside Virginia.

7. PL 86-272/Withholding. PD 12-37 (March 30, 2012). Even though a company may be exempt from Virginia income tax by virtue of PL 86-272, it still must withhold income taxes from its employees (*e.g.*, salesmen) who work in Virginia.

8. Out of State Withholding. PD 12-75 (May 9, 2012). An out of state employer is required to withhold Virginia income taxes even from non-resident employees who earn income from Virginia sources. Estimation method used by auditor did not produce a materially different result than the taxpayer's alternative proposal.

9. § 199 Deduction/Separate Return. PD 11-181 (November 1, 2011). Auditor improperly disallowed taxpayer's IRC § 199 deduction. Even though taxpayer filed a federal consolidated return and a separate Virginia return, it was entitled to its proportional share of the IRC § 199 deduction on its separate Virginia return.

10. IHC/Business Purpose. PD 11-162 (September 26, 2011). Intangible holding company could not be included in combined return, thereby allowing expenses to offset added back income items because IHC did not have nexus with Virginia. Commissioner would not consider in the context of an audit appeal taxpayer's argument that there were valid business purposes for its factoring arrangements. Taxpayer required to follow the specific statutory procedure to make that argument.

11. <u>IHC/Factoring Fees</u>. PD 11-174 (October 12, 2011). The definition of "intangible expenses and cost" specifically includes factoring fees which are required to be added back by § 58.1-402B8(a). A bankruptcy remote entity may have a valid business purpose if it facilitates the securitization of receivables and is required by unrelated third-party lenders. In order to advance this position, the taxpayer must follow the specific procedures which require it to pay the tax and file an amended return claiming a refund.

12. <u>Telecom Coop</u>. PD 12-14 (March 2, 2012). Telecommunications cooperative was exempt from both Virginia income tax and minimum tax even in years in which it failed to meet the 85% test under IRC § 501(c)(12). Commissioner holds, however, that it is nevertheless taxable on its UBTI. Income of its telecommunications subsidiary included in its consolidated federal filing is subject to tax.

13. <u>Conformity/QFT</u>. PD 12-38 (April 4, 2012); PD 12-39 (April 6, 2012). Although taxed at the lowest rate for federal income tax purposes, a qualified funeral trust does not receive that rate benefit under Virginia law. Virginia conforms based on federal adjusted gross income, not tax rates.

14. <u>Consolidated to Separate Filing</u>. PD 12-91 (June 5, 2012). When corporations for affiliates were converted from corporate form to single member LLCs, it was no longer an affiliated group for Virginia income tax purposes. Therefore, the parent corporation is required to file a separate Virginia return and does not need permission to change from consolidated to separate return filing.

II. TAX CREDITS

A. Legislation

1. <u>Historic Tax Credits</u>. Virginia deconforms to the income tax result reached by the Fourth Circuit in the *Virginia Historic* case. Gain or income recognized under federal law with respect to historic tax credits is not treated as taxable gain for Virginia income tax purposes.

B. Cases

Virginia Historic Tax Credit Fund 2001 LP, et al, v. Commissioner of Internal Revenue, 639 F.3d 129 (4th Cir. 2011), revg. T.C. Memo. 2009-295. Overruling the US Tax Court, the Fourth Circuit holds that limited partners' contributions to the capital of a partnership in exchange for the allocation of Virginia historic rehabilitation tax credits was a "disguised sale" under IRC § 707. As a consequence, the partnership recognized gain, which passed through to its general partners, when tax credits purchased from developers were sold to investors at a substantial profit. The Commonwealth of Virginia filed an *amicus curiae* brief supporting the taxpayers and defending the traditional method by which

Virginia's historic rehabilitation credits are transferred to investors. The key to the Fourth Circuit's holding was its conclusion that tax credits are "property" and not merely an allocation made within the confines of a partnership agreement. This issue had not been briefed or decided by the Tax Court. Rather, the IRS and the Tax Court focused on whether the limited partners were partners under the traditional partnership test. See *Historic Boardwalk Hall, LLC v. Commissioner of Internal Revenue*, 136 T.C. 1 (2011), on appeal to the Third Circuit at case number 11-1832, involving the same disguised sale argument with respect to federal income tax credits.

C. Rulings of the State Tax Commissioner

1. Land Preservation Credits. PD 11-154 (August 30, 2011); PD 11-155 (August 30, 2011). The issue was the value of a conservation easement. When the Department appraisal varied substantially from the taxpayer's appraisal, the Department engaged two different third party appraisals. The difference was primarily in the "before value." The taxpayer's "before value" was $22,300 per acre which compared to a purchase price two years earlier of $2,850 per acre. The Department's "before value" was $12.3 million. The third party appraiser's "before value" was $8.275 million.

   Valuation Approach. The Department ultimately accepts the third party appraisal which was based on a comparable sales approach, with adjustments. The taxpayer's use of a "discounted cash flow method" was rejected.

   Statute of Limitations. Although the Department has the authority under the statutes to increase the assessment as part of the appeal process, the Commissioner states: "The Department's policy has been to make such assessments only if the statute of limitations for otherwise making an assessment has not expired." No tax in addition to the audit assessment was asserted.

   Observation: Taxpayers who value properties using a "development approach" based on number of lots, assumed time to sell, value per lot, assumed interest rate, etc. will invariably find "push back" from the tax authorities. It is interesting, however, that many real estate professionals assert that this is exactly how the marketplace would value a property of this sort. Note, however, that the way the Commissioner did not assert his right to assess additional tax may give the taxpayer something to think about before he files suit because the trial court also has the power to increase the assessment.

III. INDIVIDUAL INCOME TAX

A. Legislation

1. Credit for State Taxes. Virginia Code § 58.1-332.2 now provides a definition of "income tax" with the stated intent to make clear that the DC Unincorporated Business Franchise Tax, Texas Margin Tax, and Ohio Commercial Activity Tax do not qualify for purposes of the individual income tax credit allowed Virginia residents. The bill is retroactive to 2007. The bill purports to confirm long-standing Virginia income tax policy.

2. Debit Cards/Refunds. Effective January 1, 2013, the 2012 - 2014 Appropriations Act requires that all individual refunds be by debit cards, not checks. Estimated to save Commonwealth $200,000 annually.

B. Rulings of the State Tax Commissioner

1. Virginia Residents. The following rulings all deal with who is a domiciliary or resident of Virginia: PD 11-171 (September 30, 2011); PD 11-165 (September 27, 2011); PD 12-26 (March 15, 2012); PD 12-8 (February 23, 2012); PD 12-11 (February 27, 2012) (service member's spouse); PD 12-16 (March 5, 2012) (service member's spouse); PD 12-30 (March 22, 2012); PD 12-86 (May 24, 2012); PD 12-99 (June 15, 2012); PD 12-112 (July 16, 2012); PD 12-113 (July 17, 2012); PD 12-136 (August 20, 2012); PD 12-140 (August 29, 2012); PD 12-115 (July 19, 2012).

2. Actual Resident/Part-Year Return. PD 11-177 (October 24, 2011). Because taxpayer spent more than 183 days in Virginia they were actual residents (even though wife's medical condition caused them to stay that long). But because they were actual residents for part of the year, they were entitled to file part-year return.

3. Service Member Residence. PD 11-158 (September 16, 2011). Spouse and her service member husband did not share the same state of domicile before being transferred to Virginia. They took steps to change their domicile to a new state, but the service member was never physically present in that state so he could not have been deemed to have established a domicile there. Since service member and wife did not have the same domicile, she does not qualify for a refund of Virginia tax based on the Service Member Civil Relief Act.

4. Service Member Spouse. PD 12-59 (April 27, 2012). A spouse can neither lose or acquire domicile or residence in a state when the spouse is present there solely to be with a service member spouse stationed there. On the other hand, the spouse can independently establish a domicile in Virginia. Spouse held to have a Virginia domicile in Virginia based on

establishment of a permanent place of abode, obtaining regular employment in Virginia and obtaining a Virginia drivers license which requires a statement of residence in Virginia.

5. Service Member Spouse. PD 12-120 (July 26, 2012). Department generally does not seek to tax a service member's spouse who maintains sufficient connections with another state to indicate intent to maintain their domicile there. These indicia would include a State of Legal Residence Certificate (DD Form 2058), drivers license, voter registration, automobile registration. In this case, the spouse had a permanent home in Virginia, a Virginia drivers license and Virginia registered motor vehicles, and registered to vote in a state where she had never physically resided. Held to be Virginia resident.

6. National Guard Pay. PD 12-25 (March 14, 2012). When one spouse is a Virginia resident and another spouses is a nonresident, deductions and exemptions are prorated between the spouses based on their relative FAGI absent proof to the contrary. Compensation for serving in the National Guard of another state is nevertheless taxable by Virginia, but subject to a credit for any taxes paid the other state. Only compensation from the Virginia National Guard is deductible.

7. Age Deduction. PD 12-56 (April 26, 2012). For purposes of determining a taxpayer's adjusted gross income and the amount of any age deduction, a taxpayer is not allowed to exclude unemployment benefits. This deduction is already reflected in arriving at federal adjusted gross income.

8. Disability/Retirement Income. PD 12-20 (March 5, 2012). Disability payments are payments made in lieu of wages. When one's status converts to "retired," payments previously made as disability payments are retirement payments and no longer deductible for Virginia income tax purposes.

9. Disability. PD 11-179 (October 25, 2011). Disability payments received as a result of military service are not includable in federal adjusted gross income. Therefore, they are not deductible from Virginia taxable income.

10. Disability Income. PD 12-134 (August 20, 2012). Amount of a DC fireman's pension was already deducted on federal return. No double deduction then allowed on the Virginia return.

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12. Death Benefits. PD 12-76 (May 9, 2012). Taxpayer notes that statute in effect in 2008 and 2009 did not require a death benefit to be paid in a lump sum in order to be excludable from Virginia taxable income.

Commissioner rules, however, that previous determinations contained the lump sum requirement and amendments to Virginia Code § 58.1-322C(32) in the 2012 Session "confirmed" the Department's interpretation.

13. IRA. PD 12-83 (May 16, 2012). There is no provision in Virginia law allowing a subtraction from Virginia taxable income for an inherited IRA. If the distribution is included in federal adjusted gross income, it is part of Virginia taxable income.

14. Itemized Deductions/Proof. PD 11-197 (December 6, 2011). Itemized deductions are allocated between resident and nonresident spouse based on relative federal adjusted gross incomes unless taxpayer can show that itemized deductions were paid by him. In this case, husband could not show that funds transferred to the "Virginia account" were not spouse's funds. Thus, he was unable to prove that his income alone was used to pay the itemized deductions.

15. Nonresident Spouse/Allocated Deductions. PD 12-94 (June 11, 2012). Auditor disallowed all itemized deductions on Virginia spouse's return because all those items had been claimed on his spouse's return in another state. Commissioner disagrees, holding that a proportional part of the itemized deductions should be allowed in Virginia based on the spouses' relative adjusted gross incomes.

16. Mortgage Deduction/Motor Home. PD 12-42 (April 12, 2012). Because the motor home had a sleeping space, kitchen and toilet, the Commissioner concludes that it can be treated as a "qualified residence" for which mortgage interest in deductible.

17. Burden of Proof. PD 12-15 (March 2, 2012). Taxpayers proved that they filed their federal returns, but were unable to produce proof that they filed a Virginia return.

18. Burden of Proof. PD 12-33 (March 26, 2012). Adjustments were made to assessment based on information provided (late) by the taxpayer.

19. Conformity/Deductions. PD 12-132 (August 10, 2012). Taxpayer's business and non-business expenses were commingled. As a result, taxpayer was unable to establish with certainty deductions claimed on its federal return and auditor estimated deductions using industry average pricing. Auditor's actions upheld.

20. Timing/Annuity Surrender. PD 12-109 (July 3, 2012). Taxpayer borrowed money from an annuity while a resident of another state, but surrendered the annuity without repaying the loan when a resident of Virginia. The taxable event was the surrender of the annuity, and that occurred when taxpayer resided in Virginia.

21. Naked Assessment. PD 12-53 (April 24, 2012). When taxpayer refused to file a Virginia return, Department made an estimated assessment based on information provided by IRS. This is sufficient, and it is taxpayer's burden to show that it is wrong.

22. Federal Audits/SOL. PD 12-3 (January 19, 2012). When taxpayer fails to report federal adjustments, the Department can make an assessment without regard to any statute of limitations. Taxpayer has 90 days to appeal. The Department will not look behind federal adjustments.

23. IRS Adjustments/SOL. PD 12-40 (April 6, 2012). Department made an audit assessment based on information from the IRS. When the IRS then withdrew its audit adjustments, the Department's assessment was effectively barred by the statute of limitations because the Department's assessment had been made more than three years after the original return was filed.

24. Federal Audit. PD 11-169 (September 29, 2011). Taxpayer who did not advise the Department of changes to his federal return cannot contest those changes. The Department will not look behind the federal audit.

25. Federal Audit. PD 12-82 (May 4, 2012). When a taxpayer is undergoing a disputed audit with the IRS, the proper way to handle the corresponding Virginia tax is to file an amended return when the federal audit is concluded.

26. IRS Information. PD 12-121 (July 26, 2012). Virginia is entitled to rely on information received from the IRS. It has a valid information sharing agreement, and such information is not illegally obtained. Taxpayer has provided no proof that the information on which the jeopardy assessment was based is wrong.

27. IRS Information. PD 12-117 (July 20, 2012). Taxpayer failed to provide any information showing that the tax information received from the IRS was incorrect.

28. Professional Return Preparer. PD 12-93 (June 8, 2012). Taxpayer failed to provide documentation supporting deductions upon request by the Department. Although taxpayer reasonably relied on a professional to prepare the tax return, that does not relieve the taxpayer of the obligation to substantiate deductions taken on the return.

29. Out-of-State Income. PD 12-17 (March 5, 2012). Income earned by a Virginia resident in New York is still taxable by Virginia, subject to a credit for New York taxes paid. The ruling discusses how to compute the credit.

30. Out-of-State Tax Credits. PD 12-7 (February 23, 2012). Virginia considers a tax credit to be a reduction of liability and not an actual payment of tax. Thus, when a tax credit is used to pay one's liability in another state, that is not considered to be a payment of tax to that state for purposes of calculating Virginia's credit for taxes paid on income to other states.

31. Out-of-State Credit. PD 11-159 (September 19, 2011). Taxpayer, a Virginia resident, failed to file Virginia returns but did pay tax on the income she earned in another state. Virginia will allow a credit for those taxes, but the taxpayer must provide Virginia returns in order to obtain that credit.

32. NATO Income. PD 12-29 (March 21, 2012). Payments made by the US to individuals working in a foreign country remain taxable by Virginia. Nevertheless, under the Ottawa Agreement, payments by NATO for services overseas are not subject to federal income taxation or Virginia taxation.

33. Foreign Tax Credit. PD 12-124 (July 31, 2012). Taxpayer recognized gain on the sale of property located in another country. Virginia no longer permits a deduction for foreign source income. Taxpayer failed to prove that tax treaty between US and the other country required a foreign tax credit on US returns.

34. Foreign Tax Credit. PD 12-110 (July 3, 2012). Income received from mutual funds and other investments which results in a foreign income tax is not income tax paid on a pension or retirement income, and therefore no credit is allowed.

35. Reciprocity. PD 12-105 (June 19, 2012). Virginia resident worked in Virginia and also Maryland and West Virginia. Employer withheld wages for all three states. Taxpayer was not entitled to claim a credit for the West Virginia and Maryland taxes because, by agreement with those states, only Virginia taxes should have been paid. Taxpayer should claim refund from West Virginia and Maryland.

36. Reciprocity/Statute of Limitations. PD 12-104 (June 19, 2012). Maryland resident incorrectly had Virginia income tax withheld from his wages and filed a nonresident Virginia income tax returns. When Maryland audited, taxpayer filed amended Virginia returns for years under Maryland audit. Although the regular statute of limitations had expired, the taxpayers did file amended return within the one year period allowed "from the final determination of a change made by any other state."

37. Statute of Limitations. PD 11-202 (December 13, 2011). Taxpayer failed to file return within the extended due date. That extension then "expires"

and any amendment of the return for that year must be filed within three years of the original due date.

38. SOL/Refunds. PD 12-114 (July 19, 2012). Claims for refund must be filed within three years of the due date of the original return.

39. SOL/Setoff. PD 12-126 (July 31, 2012). Taxpayer was asked to file a return for 2007 and responded with unfiled returns for 2004 - 2009, seeking to offset the 2007 liability with the earlier overpayments. Taxpayer's claim with respect to the earlier years was barred by the statute of limitations. No setoff and no waiver of penalty allowed. Interest is not waived because it is a fee for the use of money.

40. SOL/Assessment. PD 12-135 (August 20, 2012). The payment of tax upon the recordation of a deed is a self-assessment. Any claim for refund must be filed within 3 years of the date of that assessment.

41. SOL/Appeals. PD 12-139 (August 28, 2012). Appeals must be filed within 90 days. Requests for reconsideration within 45 days of the contested determination.

42. Statute of Limitations. PD 11-178 (October 25, 2011). Taxpayer was assessed based on information from the IRS. When taxpayer did not provide information or responses to the Department's inquiries, and no appeal was filed within 90 days, taxpayer's rights to protest administratively expired.

43. SOL/Health. PD 12-137 (August 27, 2012). The obligation to file tax returns is not suspended except in the limited circumstances provided by § 58.1-341F. When executor filed late returns for 2005 and claimed an offset for 2006 and 2007, the offset was filed too late.

44. Extensions/SOL. PD 12-84 (May 21, 2012). When a taxpayer fails to file a return by the extended due date, the conditional terms of the extension are breached. As a result, all statutes of limitations analyses are gauged from the original due date of the return, not the ineffective extended date.

45. Part Year Resident. PD 12-103 (June 19, 2012). Person who abandons his Virginia domicile and moves to another state is a part year Virginia resident. Standard deductions are prorated based on ratio of federal adjusted gross income attributable to Virginia and personal exemptions are prorated based on ratio on days of residence.

IV. RETAIL SALES & USE TAXES

A. Legislation

1. Data Centers. Virginia Code § 58.1-609.3(18) now allows a data center operator to aggregate tenant employment and investment to qualify tenants for sales tax exemption.

B. Rulings of the State Tax Commissioner

Taxable Transactions & Measure

1. LLCs. PD 12-131 (August 10, 2012). An LLC is a separate legal entity for sales and use tax purposes. Even though the taxpayer agreed that the holding company and its LLCs should be audited as a unit, the Commissioner, at the taxpayer's request, returns the audit to separately calculate the tax on each LLC. Sign manufacturers are now taxed as retailers. Posts to which signs are attached are part of the sale of the sign.

2. Intercompany Transactions. PD 11-207 (December 29, 2011). Affiliate B owned and depreciated property which was used by Affiliates C and D which reimbursed Affiliate B based on time of use. Affiliate B should purchase this property under a resale exemption certificate and charge its affiliates sales tax based on the amount paid by them.

3. Interstate Commerce. PD 12-123 (July 30, 2012). When a motor vehicle is not required to be titled in Virginia, it is technically subject to the retail sales and use tax unless an exception applies. In this case, the interstate exemption applied because the Virginia seller utilized a freight broker which arranged for delivery to the customer out of state. It was the broker, not the seller, who arranged the delivery to the seller.

4. Advertising Labor. PD 12-116 (July 19, 2012). Taxpayer designed and sold advertising flyers which were printed and mailed at a facility in Virginia. As an advertising business, the taxpayer is the user and consumer of the printing which it purchases from its parent. It does not charge tax on the sale of items to its customers. The charge for inserting and mailing the printing is part of the sales price of the printing.

5. POA Facilities. PD 12-82 (May 11, 2012). Fee charged to members of a property owners association for use of facilities are not taxable provided that no tangible personal property or services are provided in connection with the use of those facilities.

6. Greens Fees/Records. PD 12-67 (May 2, 2012). When accommodation packages include meals, attractions and golf for a single lump sum price, the entire charge is taxable. In this case, the seller had backup records showing the exact charge in each package for the usually nontaxable

greens fees. On this basis, and with the requirement that the seller collect tax in the future, the assessment was waived. Penalty was imposed, however, on meals taxes collected but remitted at a lower rate. This included the amnesty penalty on top of the regular penalty.

7. <u>Equipment with Operator</u>. PD 12-65 (April 30, 2012). When equipment is rented with a skilled operator, the transaction is generally treated as a service and not as a rental of tangible personal property. In this case, amusement games were rented with an attendant, but that "operator" did not have specific skills necessary to maintain safety and control over the equipment during operation. Accordingly, it was a taxable lease.

8. <u>Compressed Air</u>. PD 12-10 (February 27, 2012). Refilling Scuba tanks is a taxable transaction and not a nontaxable service. The air is tangible personal property. Whatever the charge is the taxable "sales price."

9. <u>Repair/Replacement Program</u>. PD 12-79 (May 9, 2012), PD 12-80 May 9, 2012). To be exempt from sales tax, repair services must be invoiced to separately state charges for labor and parts. Program by which vendor provided buyer with either replacement parts, repaired parts, etc. did not qualify because there was no separate statement showing that property owned by the taxpayer was repaired, with separate charges for parts and labor, and returned immediately.

10. <u>Sign Fabricator</u>. PD 12-70 (May 3, 2012). By specific legislation, the sale of signs is now deemed to be the sale of tangible personal property and not real estate construction. The taxable sales price includes any services that are part of the sale. When the installer incurs permit fees and other costs which it passes on to its customer, those fees are part of the taxable "sales price." If the buyer pays those fees directly, they are not part of the taxable sales price.

11. <u>Park Trailers</u>. PD 12-64 (April 30, 2012). As the provider of accommodations, a taxpayer is the user and consumer of all tangible personal property purchased and used in that business. This includes park trailers rented to customers. Auditor assessed tax at only 60% of base price, treating such trailers as modular buildings which they were not. They were taxable at 100%. Because statute of limitations on making a new assessment has expired, the Department will not assess additional tax during the appeal.

12. <u>Software/Renewals</u>. PD 12-6 (February 23, 2012). Software delivered in any tangible form (*e.g.*, CD or DVD), and any upgrades called for by the original contract, are subject to sales and use taxation unless the software meets the definition of "custom." When an upgrade is so substantial that it is separately negotiated from the original transaction, the taxability stands on new facts. If the new transaction is independent of the original

transaction (*e.g.*, not called for by the original contract) and is separately billed, it is not taxable if delivered by electronic means.

13. Authentication Solutions. PD 12-2 (January 19, 2012). Taxpayer provided authentication solutions for persons seeking to perform secure electronic commerce over the Internet. All activities were conducted on line. No tangible personal property was provided. Charges are not sales and use taxable.

14. Flooring Contractor. PD 12-127 (August 2, 2012). When taxpayer purchased flooring repairs which required the contractor to glue new flooring and remove existing tile and drywall, the activities fit exactly the definition of a contractor with respect to real estate in the regulations.

15. Lakes and Ponds. PD 11-195 (December 5, 2011). Taxation of company which provides aeration and fountain equipment for lakes and ponds depends upon whether the installations are with respect to real estate. If they are, then the taxpayer is the user and consumer. If not, they are retail sales. The provision of plants and fish in ponds is a sale of tangible personal property.

16. School Sales. PD 11-166 (September 27, 2011). Public school system sells surplus equipment supplies. Even though an entity of the Commonwealth, these sales are taxable. But if the sales occur on three or fewer occasions each calendar year, the occasional sale exemption will apply.

17. Food/Facilities Management. PD 11-188 (November 28, 2011). Taxpayer provided food preparation services for health care facilities. The health care facility was the user and consumer of the food. Therefore, the management fees were taxable at the general sales tax rate and not the reduced rate applicable to food for home consumption. On the other hand, if the facility maintained title to the food purchases, those items could be purchased at the reduced rate.

18. Food Management. PD 12-63 (April 30, 2012). Continuing care retirement community hired management company to provide food service to the CCRC's residents. The prepared meals were never transferred to the CCRC but, instead, were served directly to its residents. The CCRC is engaged in a service business. The management company performs tasks that the CCRC would otherwise would have to complete itself. Because no tangible personal property was sold by the management company to the CCRC, the management fees are not subject to tax.

19. Food Management. PD 12-62 (April 30, 2012). As a companion to PD 12-63, the food service provider sought a ruling on the taxability of its management services. Because no food or other tangible personal property was actually transferred to the customer (only to the customer's

residents), there was no taxable sale of tangible personal property. Food service manager properly paid tax on its purchases of food supplies and did not charge tax on its management fees.

20. Catered Meals. PD 12-58 (April 27, 2012). The Commissioner holds that sales of catered meals to nonprofit organizations are taxable if the nonprofit's exemption applies only to tangible personal property. "Because preparation services must be performed in order to provide catered food, the sale of such constitutes a taxable service … ." **Comment**. It is remarkable that the Department issued this ruling without making a single citation to the Supreme Court of Virginia's decision in *Chesapeake Hospital Authority v. Commonwealth*, 262 Va. 551 (2001). That case rejected the Department's attempts to impose use tax on coffee, donuts and prepared meals provided by hospitals to doctors, nurses, directors, and other persons who are not patients. The Supreme Court's analysis, without complaint by the Department, was that meals were tangible personal property. To argue that something becomes a "taxable service" because services are required in preparing the article, would suggest that an automobile or any tangible good that is manufactured is a taxable service because it requires significant services to create it. The Department's reliance on a series of rulings related to the sale of meals to government entities for consumption by individuals is especially questionable given the Supreme Court's holding in *Chesapeake Hospital Authority*, a government entity.

21. Excise Tax. PD 12-90 (June 5, 2012). No resale exemption was allowed for repair parts provided with respect to rental motor vehicles because the taxpayer did not show that either the motor vehicle or retail sales tax had been paid in connection with the leases of those vehicles. No sales tax had been paid on the *manufacturers'* excise tax with respect to tires. The statutory exclusion for excise taxes applies only to *retailers'* excise taxes. Because taxpayer had not paid use taxes for the periods in question, an additional assessment was issued in connection with the appeal.

Exemptions: Industrial

22. Micro Brewing/Manufacturing. PD 12-125 (July 31, 2012). Sixty-seven percent (67%) of a micro brewery's production was sold to on-site beer customers. Commissioner denies the direct use in manufacturing exemption because predominant activity was making retail sales, not manufacturing beer for sale.

23. Packing Equipment. PD 12-119 (July 25, 2012). Wholesaler of packaging products also operated machinery that converted corrugated cardboard into self-locking boxes. Although this was potentially an industrial processing activity, it was conducted by a wholesale merchant business, the primary activity of which was not manufacturing. The direct use exemption was not available.

24. Wood Products Harvester. PD 12-1 (January 12, 2012). Taxpayer operated a mulch yard. It was also a real property contractor that removed trees and vegetation from job sites and then shipped them into wood waste and other materials. Commissioner holds that the industrial exemptions are available only for operations at a single plant site and do not apply to equipment that moves between locations. Accordingly, the chippers, mulchers, etc. used outside the mulch yard were taxable. The forest products exemption did not apply because the equipment was not necessary to harvesting the trees.

25. Manufacturing/Direct Use. PD 12-118 (July 23, 2012). Software managed and monitored work in progress on the factory floor, providing key information to support supply chain management and sales. This was an administrative function and not qualified for the direct use exemption. Similarly, a wireless gun system was utilized for internal tracking and inventory control and not exempt. A maintenance contract for that wireless gun system was also taxable, based on one-half of the charge.

26. Manufacturing/Vending Machine. PD 11-168 (September 29, 2011). Manufacturer used vending machine to dispense exempt safety equipment. Held that the vending machine was not directly used in manufacturing and was taxable.

27. Direct Use Manufacturing. PD 12-52 (April 23, 2012). Floor scrubbers used to vacuum and clean floors between production runs were not used directly in manufacturing. They were not used as an immediate part of the production process. They were not used during production. Racks used to store both raw materials and finished goods were taxable to the extent used for finished goods. The statute expressly provides an exemption for the handling and storage of raw materials, but not for finished goods. Forklifts previously held to be taxable, because used in a taxable construction process, were held to be nontaxable during the audit because used in an exempt activity then. The key was that the forklifts were under a monthly lease, so the exemption applied for the periods in which the preponderance of the use was exempt.

28. Natural Gas Extraction/Direct Use. PD 12-73 (May 9, 2012). The pollution control exemption for materials certified by the DMME ended July 1, 2006. As to the taxpayer's claim for exemption for tracer wire, which was placed in underground pipes to enable them to be traced, and stone used as backfill for those pipes, the Commissioner rules they are not "indispensable to actual production" and therefore are not directly used and exempt. Taxpayer also argued that stone used in providing access to well site areas was exempt in greater proportion than had been allowed by the auditor. Commissioner also holds that 100% of this stone is taxable because not directly used. **Observation**. It appears that the Commissioner reversed the auditor's position which had allowed a partial exemption, but did not increase the assessment by this amount. If the

taxpayer had not taken an aggressive appeal on what constitutes "directly used," it would have had a precedent it could have relied on in future audits for deducting at least a portion of the stone used in well site access.

29. Shipping Pallets. PD 12-87 (May 24, 2012). Wooden pallets used to ship goods are generally treated as taxable under the regulations. In this case, however, the wholesaler purchased pallets with the express intent of reselling them. When goods were packaged for sale using the pallets, there was a separate charge to the customer for the pallet. The pallets were not returnable and not reusable by the taxpayer. The Commissioner allows the resale exemption for these pallets.

30. Strapping Materials. PD 12-55 (April 25, 2012). A yarn manufacturer utilized plastic and steel strapping materials in shipping products to customers. Although the Commissioner declines to allow a packaging exemption (bundling is not packaging), he does allow a resale exemption because the strapping materials were essentially resold to the customer and the manufacturer, which did not provide any transportation services, did not make any taxable use of the strapping.

31. Manufactured Homes. PD 12-19 (March 5, 2012). Whether "set up components" of a manufactured home are subject to the 3% motor vehicle sales tax or the 5% retail sales tax depends on whether the manufactured home remains tangible personal property upon installation. If they are and the cost of set up components are included in the sales price of the manufactured home, they are subject to the 3% tax. If the manufactured home is affixed to a permanent foundation and included in the sale of real estate, the set up components are subject to the 5% retail sales and use tax. The tax treatment of HVAC units depends on whether the manufactured home is real estate at the time of attachment. If it is, then the contractor making the installation is a real estate contractor and must pay the tax.

32. Pollution Control. PD 11-172 (October 6, 2011). Without certification by the DEQ, no pollution control exemption is available.

33. Pollution Control. PD 12-96 (June 13, 2012). Taxpayer sought an exemption for pollution control equipment which the DEQ would not certify because it was used at multiple sites and therefore was "not a permanent part of the job or actually fixed to the job." Commissioner holds that, without certification, there is no sales and use tax exemption.

Exemptions: General

34. Charities. PD 12-130 (August 9, 2012). A person providing entertainment services is engaged in a service business and is the user and consumer of all tangible personal property used in providing those services. Even though one of the contracts was for a nonprofit organization (the "USO"), the nonprofit cannot transfer its tax exempt

status to anyone else. Purchases by the service provider are still taxable even though reimbursed by the USO.

35. <u>Package Air Carrier</u>. PD 12-111 (July 9, 2012). Taxpayer is described as equivalent of UPS or FedEx, utilizing both motor vehicles and air craft to transport property. It is licensed by the FAA as an air carrier. Commissioner holds that the exemption applicable to "airlines operating in interstate or foreign commerce as a common carrier providing scheduled air service on a continuing basis …" applies. Moreover, he holds that the exemption will also apply to the motor vehicles and other equipment that are used in connection with providing this common carrier service.

36. <u>Prosthetic Devices</u>. PD 12-95 (June 13, 2012). For a prosthetic device or other durable medical equipment to be exempt when sold to a medical practice or for profit hospital, the item must be specifically purchased for one individual on a doctor's written prescription. All purchases of prosthetic devices are taxable. Vendors' records must include the name of the specific individual and the written prescription. Sales of durable medical equipment to not for profit hospitals that have obtained exemption letters are not taxable.

37. <u>Egg Production</u>. PD 11-175 (October 13, 2011). Taxpayer washed, graded and packaged eggs. Machine used to wash plastic egg trays that carried eggs from the farm to the factory was used in general maintenance and was not exempt. "Honey wagon" that took waste water from the egg cleaning process and spread it on farm land was not used directly in processing eggs. Although fans used to dry manure underneath the chicken houses were not used directly in processing the eggs, the agricultural exemption did apply.

38. <u>Data Centers</u>. PD 11-183 (October 27, 2011). Virginia Code § 58.1-609.3 provides a sales tax exemption for purchases by certain data centers if there is a $150 million investment and 50 jobs are created. This ruling confirms that the jobs can be created by tenants of a data center and do not have to be created by the entity owning the data center. Note 2012 legislation allowing data center owner to enter into one MOU with the VEDP on behalf of itself and its tenants.

39. <u>Well Drilling Truck</u>. PD 12-28 (March 19, 2012). Legislation now codifies the Department's policy of not imposing a retail sales and use tax on the sale or lease of motor vehicles with a gross vehicle weight of 26,001 or more.

40. <u>Occasional Sale/Interest</u>. PD 12-69 (May 3, 2012). Generator purchased by taxpayer from its parent company qualifies for the occasional sale exemption. Taxpayer's request to abate interest because of excessive time required for audit denied. Interest is a fee for the use of money. Delay

was not deliberate. Much of delay was to accommodate taxpayer's need to provide documentation.

Audits & Procedure

41. Corrected Mistakes. PD 12-129 (August 7, 2012). Taxpayer was not excused from its duty to pay incorrectly calculated sales tax simply because its customers failed to advise it of the tax collection errors. In extrapolating sample information, the Commissioner holds that auditors correctly included errors in the sample that were corrected subsequently. The Commissioner will allow credit for the actual amount of tax in each item, but will not change the sample. **Observation**. The Department continues on this unfair path. If a mistake is corrected, there is no mistake to be assessed. How can it be fair to include a nonexistent mistake in the extrapolated sample?

42. Sample Credits. PD 12-133 (August 20, 2012). Even though the taxpayer's detailed sample shows a substantially lower tax due, Commissioner upholds the audit sample methodology because taxpayer did not prove any of the sales taxed in the sampling process were erroneously taxed. When taxpayer proved that its customers had paid use tax on items included in the sample, Commissioner allows a credit for the actual tax paid, but does not remove the erroneous transactions from the sample.

43. Unreported Sales. PD 12-35 (March 28, 2012). Taxpayer did not file returns, including returns prepared by CPA, and did not remit taxes collected from customers. Department estimated omitted taxes and applied both fraud penalty and amnesty penalty.

44. Exemption Certificates. PD 12-68 (May 3, 2012). When someone accepts an exemption certificate, he must exercise reasonable care and judgment to determine that the certificate covers the types of property being sold. Accordingly, a manufacturing exemption certificate was not acceptable to exempt envelopes and invoices; but envelopes, invoice forms, flash drives, and gold pens reasonably could have been acquired by the customers in question for resale. A separately stated charge for postage is exempt as "transportation out."

45. Exemption Certificates. PD 11-206 (December 20, 2011). Because taxpayer did not obtain exemption certificates before the audit and contemporaneous with the sales, each sale transaction is reviewed without any presumption in the taxpayer's favor.

46. Exemption Certificate. PD 12-71 (May 4, 2012). Exemption certificates received after the date of a sales transaction are not accorded the presumption of correctness. The Commissioner goes on, however, to state that "The Code of Virginia very clearly provides that a dealer must charge

and collect the Virginia sales and use tax from its customers on the sale of tangible personal property, unless the Taxpayer takes from its customer a valid exemption certificate. Without such exemption certificate, the transaction at issue is subject to the sales tax." **Comment**. This is not what the statute says and not even what the regulations say. Both Virginia Code § 58.1-623 and 23 VAC 10-210-280 state that transactions are subject to tax until the contrary is established. Taking a valid exemption certificate will relieve the taxpayer of the burden of proof, but even without such an exemption certificate, the taxpayer can prove that a valid resale has occurred.

47. Truck Scales/Exemption Certificate. PD 12-98 (June 14, 2012). A resale exemption certificate for an installed truck scale was rejected. The certificate was signed three years after the sale, not contemporaneously with the sale. Moreover, it is not credible to argue that a customer to whom a scale with installation is being sold, intends to resell that real estate improvement.

48. Burden of Proof. PD 12-31 (March 23, 2012). Daycare center was assessed use tax because it could not prove that it had paid the sales tax on various purchases.

49. Burden of Proof. PD 12-41 (April 12, 2012). Because taxpayer failed to provide accounting records reconciling its sales tax reports with its sales, auditor was justified in making an estimated assessment based on best information available.

50. Faulty Dealer Invoices. PD 12-57 (April 27, 2012). Although dealers failed to separately state the tax on invoices, one dealer provided a notarized statement to the effect that tax had been included in the purchase price and remitted to the Tax Department. Nevertheless, the Department holds that the contractor being audited cannot prove that he paid the sales tax to his vendor. **Comment**. Given the notarized statement from the vendor admitting that it charged and remitted the tax, this ruling seems unusually harsh. The only explanation is the comment at the end of the ruling that there was somehow other "required documentation necessary to allow for an adjustment."

51. Penalties. PD 11-184 (November 8, 2011). Restaurant collected tax from customers but failed to remit it to the Department, claiming that its failure was due to hospital stay by the responsible employee. Penalty was not waived.

52. Manufacturing Direct Use/Penalties. PD 12-48 (April 23, 2012). No exemption for packaging materials used by manufacturer was available because taxpayer was not engaged in manufacturing. It simply applied labels and hangers to otherwise finished goods. This was distribution, not manufacturing. **Observation**. This ruling is a good example of the "first

generation audit" rule for waiving penalties. Because the wooden pallets in issue had not been taxed in previous audits, they were a new issue in this audit. The calculation of penalties was redone to take into account this first generation audit issue.

53. Interest. PD 12-81 (May 11, 2012). Taxpayer's previous appeal and attempt to settle sales tax audit had been rejected. On petition for rehearing, taxpayer finally provides documentation to substantiate audit adjustments. Taxpayer's request for an abatement of interest and penalties is denied. Interest is a charge for the use of money. Abatement of penalties depends on meeting the standards set forth in the regulations.

54. Unremitted Tax. PD 12-102 (June 19, 2012). Taxpayer incorrectly charged 5% on sales of donuts, coffee and other food that qualified for the reduced rate on for food home consumption. It remitted only 2.5%. Although it remitted all the law required, it is nevertheless required to remit all that it collects. Penalties, including amnesty penalties, not waived.

55. Refunds. PD 11-176 (October 21, 2011). Taxpayer mistakenly charged tax based on the list price and not the discounted price. Taxes payable on the actual price charged the customer. Refunds are available if the taxpayer can show it is refunded to its customers the erroneous overpayments.

56. Officer Liability. PD 12-49 (April 23, 2012). Commissioner concludes that only a person who is an officer or employee of the corporation can be held liable for unpaid taxes. Accordingly, a 50% owner who is not an officer or employee was not liable. A 25% owner who served as Secretary but had retired from active involvement in corporate affairs, writing no checks or make any business decisions, likewise was not liable for the tax.

57. Office Liability. PD 12-50 (April 23, 2012). Crying before he was hurt, taxpayer filed administrative appeal before any unpaid taxes were assessed against him. Commissioner treats his "appeal" as a request for ruling but declines to rule because there was no proof as to the taxpayer's actual duties with the corporation, no proof of his knowledge about unpaid tax liability; and no proof about his check signing authority.

58. Officer Liability. PD 12-51 (April 23, 2012). Another officer of the company noted his appeal before receiving an assessment, and again the Commissioner treats it as a ruling request. Here, the taxpayer was an officer, was aware of the unpaid taxes, had the authority to prevent the tax payment failure, and may have failed to pay over the taxes once they were known. Nevertheless, the taxpayer was not responsible for the taxes because he did not have the specific corporate duty of timely reporting and paying the tax.

59. <u>Responsible Officer</u>. PD 11-163 (September 26, 2011). President of corporation was not the "responsible officer" who failed to report and pay taxes. Those duties were the responsibility of the CFO. Because the President lacked knowledge of the corporation's failure to report and pay use taxes, the personal assessment against the President was abated.

60. <u>Responsible Officer</u>. PD 11-164 (September 27, 2011). Unpaid corporate taxes were "converted" to this individual because her social security number appeared on several tax returns of the company. Based on an affidavit provided by the taxpayer that she was never an officer, shareholder, director or even employee of the company, the converted assessment was abated.

61. <u>Officer Liability</u>. PD 12-100 (June 15, 2012). Although President of the corporation and a 20% stockholder, taxpayer's duty focused on overseeing and performing tire sales, installation, repair and servicing. Financial matters were handled by another officer. When President learned that taxes had not been paid, he guaranteed a loan and was told that they had been paid. President is not personally responsible for the corporation's unpaid taxes. He did not have the specific duty of reporting and paying taxes and lacked actual knowledge that they had not been paid.

62. <u>Unremitted Tax</u> PD 12-74 (May 9, 2012). Taxpayer collected tax on the full amount for installation of floor coverings, but did not remit the tax attributable to installation labor which had not been separately stated on invoices. Taxpayer must remit all taxes collected from customers, whether properly collected or not.

63. <u>Communication Services/Effective Date</u>. PD 11-204 and PD 11-205 (December 20, 2011). Even though the legislation became effective January 1, 2007, it is applied to transactions before that date if reflected in a bill issued after the effective date.

64. <u>Communications Tax Refunds</u>. PD 12-43 (April 16, 2012). As an instrumentality of the Commonwealth, the Town was not subject to the communications sales tax. This is so even though it had not yet filed exemption certificates with the telephone company. Once those certificates are filed, it is entitled to a refund from the communications service provider for up to two years. **Comment**. Note that this is a tax administered by the Department of Taxation. Although the provisions allowing for a refund from the telecommunications service provider are limited to two years, is there any reason that a three year refund is not available from the Department of Taxation under Virginia Code § 58.1-1823?

65. <u>Late Appeal</u>. PD 12-54 (April 24, 2012). The appeal was not timely filed because not filed within 90 days. Moreover, because the original

assessment was not paid within 30 days of its issuance, a 20% amnesty penalty was applied.

66. Faxed Appeals. PD 12-97 (June 13, 2012). When an appeal is filed by fax, it must be dated and received on or before the ninetieth calendar day after the date of assessment. This appeal was neither transmitted nor received within the ninety days.

67. Statute of Limitations. PD 11-208 (December 30, 2011). The Department strictly enforce the 90 day limitations for filing a complete appeal.

68. Ice Cream/Liens. PD 12-9 (February 27, 2012). An ice cream shop that sells for immediate consumption is not entitled to charge the reduced food tax rate for "home consumption." Department properly put a lien on the taxpayer's accounts when its bill rendered 30 days after the assessment was not paid. This was so even though a timely appeal was filed thereafter. **Comment**. To avoid this problem with liens and other collection actions, be sure to file a Notice of Intent to Appeal with the Department within 30 days of the date of assessment. This will generally forestall collection efforts until the appeal is completed, assuming that a timely appeal is filed within 90 days of the date of assessment.

V. BUSINESS LICENSE TAX

A. Cases

1. *Ford Motor Credit Company v. Chesterfield County*, 281 Va. 321 (2011). The Supreme Court of Virginia reversed the holding of the Circuit Court that allowed Chesterfield County to tax 100% of the interest earned on loans "originated" in the regional office located in that County. The loans were documented at dealerships, forwarded to the regional office for review in a three-day process, and then sent to offices in Tennessee and Maryland where all continuing relationships with customers, including billing and collection, were handled during the multiyear lives of the loans. The activities of the Chesterfield office were subject to the supervision and direction of the Michigan headquarters which also produced all of the funds that were loaned to customers. Under these facts, the Supreme Court held that it could not reasonably be said that all the income generating activities of this business occurred in Chesterfield County. The Supreme Court further held that because of the nature of Ford Credit's business, it was appropriate to use payroll apportionment to determine the revenues taxable by Chesterfield County. The Supreme Court rejected the County's argument that because an internal accounting report, based on contract accounting, showed exactly the revenues attributable to loans originated in the County, that apportionment and other situs rules were inappropriate. As the Supreme Court noted, the statutes require situs rules based on where services are rendered, and a contract driven accounting system does not do that. Finally, the Supreme

Court held that Ford Credit is also entitled to deduct from its taxable base receipts attributable to business in other states, under Virginia Code § 58.1-3732B(2).

B. Attorney General's Opinions

1. Military Bases. 2012 Va. AG Lexis 9 (February 24, 2012). Although the United States has exclusive jurisdiction over the Little Creek Naval Base, the Buck Act permits the imposition of gross receipts taxes and therefore a BPOL tax. Whether the contractor's construction trailer satisfies the definite place of business requirement is a factual question on which the Attorney General will not opine.

2. Severance Tax. 10 OAG 110 (August 5, 2011). Persons engaged in severing gases from the earth who do not do so in connection with coal mining may take deductions for expenses incurred after the gas was used or sold for use within the taxing locality or after it is placed in transit for shipment from the taxing locality. The tax is based on gross receipts, defined as "the fair market value measured at the time such coal or gases are utilized or sold for utilization…or at the time they are placed in transit for shipment [from the locality]." Va. Code § 58.1-3712. Although the term gross receipts generally does not contemplate deductions, the statute nevertheless permits them, except if the taxpayer engages in the production and operation of severing cases from the earth in connection with coal mining.

C. Rulings of the State Tax Commissioner

Exclusions, Exemptions and Reductions

1. Severance Tax. PD 12-44 (April 18, 2012). When natural gas is placed in transit at a wellhead in the County, gross receipts for local severance tax purposes do not include value added after that time. This would allow a deduction, for example, for transportation, compression and other costs incurred after transportation begins.

2. Place of Business. PD 11-161 (September 20, 2011). Out-of-state company had employees permanently located at a client's offices in Virginia providing "infrastructure support and maintenance services." The company did not advertise this as an office. Nevertheless, the Commissioner holds that it is a definite place of business and subject to local license taxation.

3. Place of Business. PD 11-192 (November 28, 2011). Taxpayer had approximately 200 - 500 employees assigned to work on a continuing basis at a military installation. Workspace for the exclusive use of the taxpayer was provided by the military. This constituted a definite place of business, and the gross receipts attributable to the services provided at that

military installation were taxable in that locality. Second locality where the taxpayer's home office was located could not tax those receipts.

4. Parent Subsidiary. PD 11-167 (September 28, 2011). Virginia locality tried to assess tax against foreign parent based on payments it made to Virginia subsidiary which provided marketing, procurement and other business services for it. Commissioner holds that locality cannot pierce the corporate veil in this fashion. Only the local subsidiary is taxable (minimum fee only) because intercompany receipts are not taxable.

5. Rental Business. PD 11-187 (November 23, 2011). Taxpayer provided furnished housing to employees of its clients, all utilities included. This is deemed to be the business of renting real estate which is taxable in some Virginia localities. The rental property itself is considered to be a definite place of business. **Note**. That the Commissioner holds that the prohibition against the imposition of BPOL taxes on real estate applies only when the lessor is the owner of the property.

6. Pollution Control. PD 12-24 (March 12, 2012). The exemption for pollution control facilities provided by Virginia Code § 58.1-3660 applies only to property taxes, not BPOL taxes. **Comment**. Why does the Commissioner engage in analysis about rules of construction and strictly construing exemptions? The statute is clear.

7. Affiliated Group. PD 12-34 (March 26, 2012). S corporation provided services to group of related entities ultimately controlled by the same stockholders, three trusts. The services were provided to limited partnerships of which the S corporation was a general partner. On the specific facts presented, the Commissioner holds that the intercompany transactions between the taxpayer and the first tier and second tier limited partnerships were not exempt from BPOL taxation.

8. Out of State Deduction/Apportionment. PD 12-146 (August 31, 2012). Following the lead of Arlington and Hampton, this locality declined to allow the taxpayer to take a 58.1-3732B2 deduction arguing that payroll apportionment already provided an adequate deduction for out of state receipts. The State Tax Commissioner, following previous rulings, states that the out of state deduction must be determined using payroll apportionment. **Query**. The state ruling orders the locality to make a new assessment utilizing payroll apportionment to determine the out of state deduction. Will the locality do that? Arlington and Hampton did not.

9. Interstate Deduction. PD 12-88 & 12-89 (May 31, 2012). This is the third time that the State Tax Commissioner has had to consider these same appeals from the same two localities. In response to a convoluted argument about how to compute the interstate deduction, the Commissioner provides a very specific three step process:

1. Do local employees in Virginia participate in interstate transactions?

2. Can specific receipts be traced to this local participation? If so, deduct those receipts. If specific linkage is not possible because payroll apportionment was used to determine taxable receipts, then

3. Apply the same payroll factor to determine the deductible portion of gross receipts attributable to states in which the taxpayer filed an income tax return.

10. Agency. PD 12-77 (May 9, 2012). Country club held taxable with respect to amounts collected from members that were passed on in payment of separately incorporated pro shops, as dues to independent golf organizations, and as a voluntary bonus pool for employees. Commissioner holds that taxpayer failed to prove the three elements necessary to establish that these receipts were held in an agency capacity: (i) contract with third party, (ii) noncommingling of funds, and (iii) not reported on federal income tax return. **Comment**. Part of the problem in this appeal is that the taxpayer did not cooperate with requests by the Department of Taxation for additional information. Beyond that, bear in mind that only those gross receipts attributable to the exercise of a licensed privilege and derived in the ordinary course of business are subject to gross receipts taxation. *See* Va. Code § 58.1-3732A.

Classification

11. Manufacturing/Wholesaling. PD 12-4 (February 3, 2012). Manufacturer purchased chemicals from affiliates and sold them through a warehouse located at its manufacturing site. Department holds that manufacturer is liable for a BPOL tax based on chemicals not manufactured on site. That wholesaling business is not ancillary to the manufacturing business.

12. Manufacturing. PD 12-66 (May 30, 2012). Locality taxes company as a "business service" apparently without considering the total activities of the business. Commissioner holds that when a company has multiple facilities that constitute a single business, all of them must be considered together to determine whether the taxpayer is a manufacturer and taxable as such. In this case, the printer was a manufacturer and not subject to BPOL taxation on gross receipts from the sale of goods at the place of manufacturer.

VI. PROPERTY TAXES

A. Legislation

1. Transit Companies. Virginia Code § 58.1-609.1 17 exempts tangible personal property sold or used by a transit company that is operated or controlled by a county, city or town.

B. Court Decisions

1. *City of Richmond v. SunTrust Bank*, 283 Va. 439 (March 2, 2012). Richmond Redevelopment Housing Authority and SunTrust owned certain property as tenants in common. Under an operating agreement, SunTrust had exclusive use of the property. Supreme Court holds that City has no authority to impose a property tax on SunTrust with respect to the portion of the property owned by the RRHA, a state political entity. SunTrust's right to possession was grounded in the law relating to a tenancy in common, not a lease. (City's argument that the operating agreement was tantamount to a lease was barred because trial court's finding to the contrary was not assigned as error.)

2. *Army-Navy Country Club v. City of Fairfax*, Cir. Ct. Fairfax County, 2012 Va. Cir. LEXIS 21 (February 17, 2012). Based on long Virginia precedent, trial court holds that City's use of the "development cost" was an inappropriate valuation method. It then considered the valuation opinions of the two experts and concluded that the taxpayer's expert was more credible.

3. *City of Richmond v. Jackson Ward Partners*, 284 Va. 8 (June 7, 2012). In a 5 - 2 decision, the Supreme Court holds that the taxpayer failed to carry its burden of proof, as a matter of law, because its expert appraiser failed to value each of 8 separate parcels separately. Rather, the appraiser valued the low income housing project as a whole, determined that fair market value, and allocated it amount the 8 separate parcels/units mathematically.

4. *NA Properties, Inc. v. Loudoun County*, Cir. Ct. Loudoun County, 2012 Va. Cir. Lexis 58 (July 3, 2012). Trial court finds that taxpayer's appraiser failed to prove that County's assessment was erroneous. It was not proper for appraiser to speculate on what could be done to property to make it more valuable. Moreover, the appraiser utilized a development density analysis that was based solely on his opinion without any substantiation.

C. Rulings of State Tax Commissioner

1. M&T/Pollution Control. PD 11-110 (June 17, 2011). Equipment used to remove fumes and particulates during the manufacturing process was possibly M&T if it helped provide power to the manufacturing process. A

fines bin that collected wood material and returned it to the manufacturing process was held to be M&T.

Taxpayer complained that locality was double taxing when it treated capitalized costs relating to repair and replacement of machine parts as taxable. Commissioner holds that the issue is the fair market value of the machinery in question. Locality cannot simply add cost unless that new cost, when added to the original cost, can be shown to reflect true fair market value.

Locality must pay interest on refunds at the same rate it charges interest on delinquencies.

2. <u>M&T/Valuation</u>. PD 12-27 (March 16, 2012) When locality values based on original cost, that is the cost paid by the original purchaser of the property. Case returned to locality to consider new appraisal provided by taxpayer. **Comment**. Commissioner makes the contradictory statement that locality must assess at fair market value, but cannot consider technological obsolescence in valuing machinery and tools.

3. <u>Computer Valuation</u>. PD 12-145 (August 30, 2012). Locality valued computers and peripherals utilizing a percentage of original cost. Taxpayer supplied an appraisal. State Tax Commissioner remands the case to the locality with instructions to consider the taxpayer's appraisal. **Observation**. Note the Department of Taxation's great reluctance to express any view as to the validity of a taxpayer's appraisal, thereby giving the locality broad discretion to refuse to follow it based on nit-picking analysis.

4. <u>Premature Appeal</u>. PD 12-144 (August 30, 2012). Taxpayer was faced with a jeopardy assessment when it failed to file a property tax return. When it appealed to the Commissioner of Revenue who requested additional information, the taxpayer then appealed to the State. The State Tax Commissioner holds that he has no authority to hear the appeal because there has been no "final local determination." **Observation**. On the facts of this case, this is probably a correct result. Note, however, how injecting these sorts of technicalities into the administrative appeal process provides opportunities for localities to "game the system."

5. <u>Jurisdiction/Court Proceeding</u>. PD 11-200 (December 12, 2011). When taxpayer appeals its assessments both to the State Tax Commissioner and the Circuit Court, the Department's policy is to defer to the Circuit Court. **Observation**. Sometimes it is necessary to file a protective claim with the court while the administrative process proceeds. If this is done, consider not serving the court's suit immediately in an effort to let the administrative process proceed uninterrupted. If the court filing is discovered, it may be possible to convince the Department to rule anyway

on the theory that the filing is simply a precaution and the court has not actually taken the case up.

6. Railroad/Operating Property. PD 11-201 (December 12, 2011). Based on the fact that rail line was not in use and parts of its had been paved over, staff treated the property as non-operating for local tax purposes. The Commissioner reversed this. Under the rules of the Surface Transportation Board, property remains as operating property until it is permanently withdrawn from service. Taxpayer had retained a right to utilize the line and its withdrawal from service was not authorized by the STB.

7. Vehicle Valuation. PD 11-198 (December 7, 2011). Taxpayer contested locality's use of NADA value for recreational vehicle instead of arms' length sales price. Department declines to rule because the local mobile property tax is not a "local business tax" over which the Department has appellate jurisdiction.

8. Rehearing. PD 12-143 (August 29, 2012). Taxpayer requested rehearing on the basis that the Department has misstated the facts in its original opinion. Commissioner holds that any misstatement of facts was the fault of the taxpayer. Although this suggests that the Department will not grant a rehearing when this occurs, the Commissioner goes on to rule on the merits that the taxpayer has not proved that the locality's method for valuing taxi cabs is illegal.

9. Interstate Trucker. PD 11-200 (December 12, 2011). Interstate trucking company wanted to limit property taxation by locality to those trucks shown by GPS tracking to have been present on January 1. Department rules that locality can tax vehicles that are "normally garaged" in locality. GPS data showed that trucks were often in the locality. Taxpayer failed to carry burden to prove locality's factual determination wrong.

10. Taxi Cabs. PD 12-60 (April 27, 2012). Although taxi cabs are treated as a separate classification of property for valuation purposes in the Code, the City valued the taxpayer's fleet using a recognized pricing guide. The burden of proof is on the taxpayer to show that the City's valuation is wrong. The fact that other localities value taxi cabs differently does not suffice. Case returned to locality to provide taxpayer with an opportunity to provide detailed information concerning the condition of its vehicles.

VII. MISCELLANEOUS TAX

A. Legislation

1. Consumer Utility Tax. Virginia Code § 58.1-3814 is amended to make clear that localities cannot tax natural gas used by electric utilities and coops to generate electricity for sale.

2. Roll Your Own. Virginia Code § 58.1-1003.3 now classifies a retailer who has machines that enable customers to "roll their own" as a cigarette manufacturer, with those cigarettes being subject to tax.

3. Defense Contractors. Virginia Code § 58.1-3245.12 is amended to allow local government to establish a defense production and support services zone and provide regulatory flexibility and certain incentives in that zone.

B. Rulings of the State Tax Commissioner

1. Port Volume Increase Tax Credit Guidelines. PD 12-21 (March 5, 2012). This document sets for the Department's interpretation of the income tax credit allowed for taxpayers engaged in manufacturing or distributing manufactured goods through Virginia port facilities.

2. Litter Tax. PD 12-13 (March 2, 2012). Taxpayer owns and rents residential property. This is not one of the businesses that is required to pay a litter tax.

3. Tobacco/Bidis. PD 12-18 (March 5, 2012). A penalty of 500% of the retail value was imposed on wholesaler for selling contraband cigarettes known as "bidis." Department is charged by statute with administering the cigarette tax and has full authority to impose such penalties.

4. Bank Franchise Tax. PD 11-182 (November 30, 2011). Tax Department acquiesces in the circuit court opinion *AMG National Trust Bank v. Commonwealth*, Cir. Ct. Norfolk Docket No. CL 10-3031 (July 2011). Accordingly, national bank with a mortgage loan office operated in Virginia is subject to the bank franchise tax and not the corporate net income tax. Because bank has no deposits in Virginia, the Department will use an alternative apportionment method involving a single property factor.

5. Recordation Tax/Refinancing. PD 11-160 (September 19, 2011). To be exempt as a refinancing of the "existing debt with the same lender," Department requires that taxpayer refinance his debt with the mortgage lender that holds the deed of trust at the time of the refinancing. In this case, the original lender had assigned its interest in the mortgage to a bank. Accordingly, that original lender was not the "same lender" for a refinancing.

6. Recordation Tax/Value. PD 12-22 (March 9, 2012). Clerk assessed recordation tax based on local assessed value, not consideration paid. Commissioner holds that tax base is a factual determination best made by the local clerk. While assessed value is one factor, it is not the only basis for determining fair market value. Case returned to local clerk for further consideration.

7. Recordation Tax/Value. PD 11-191 (November 30, 2011). Determination of fair market value of property for purposes of the recordation tax is a factual matter. The Clerk is entitled to use the assessed value, but also can take into consideration appraisals and other factual information.

8. Recordation/Value. PD 11-173 (October 6, 2011). Determination of basis on which to assess recordation tax is a factual issue, and the determination of fair market value is a decision best made by the Clerk taking into account all the facts and circumstances. The use of the assessed value is presumptively correct, but an arms' length purchase by the recording party is also information to be considered.

9. Recordation Tax. PD 12-61 (April 27, 2012). Determination of fair market value on which recordation tax is assessed is a factual matter for the clerk of court. The value as assessed for real estate tax purposes is presumed accurate. Evidence that the taxpayer actually paid less for the property should also be considered.

10. Recordation Tax/LLC Transfer. PD 11-186 (November 16, 2011). Corp A and Corp B contributed assets to a new LLC. As part of the transaction, Corp B contributed real estate to the LLC and received a 42% interest in return. The Commissioner rules that this transfer is not exempt from recordation tax. (i) It is not a merger or consolidation which require that at least one of the entities cease to exist after the transaction. Neither corporation ceased to exist. (ii) It is not a reorganization because the taxpayer was an LLC, not a corporation. (iii) The transaction is not exempt, under the rule of strict construction, as the contribution of property to a partnership. This was an LLC. (iv) Finally, the exemption for contributions when grantors received at least 50% of the interest in the LLC does not apply because the grantor here retained only a 42% interest. The Commissioner acknowledges, however, that some tax refund may be due on account of over-valuation or on the theory that the transferring Corp B only transferred half of the property.

11. Recordation Tax/Refinancing. PD 11-194 (December 2, 2011). On a petition for rehearing, the decision in PD 11-19 is reaffirmed.

VIII. TRENDS

Addback Litigation. The Virginia Department of Taxation's interpretation of the addback legislation enacted in 2004 has been controversial, to say the least. Cases are now queuing up for litigation. The Department has already lost in the trial court the first case dealing with the safe harbor for entities that have more than one-third of their revenues from unrelated parties and deal with related parties on the same basis. As reported above, the trial court agreed with Wendy's International that the statute is plain and unambiguous. Anticipate that there will be a trial in the next twelve months of the safe harbor for royalties that are taxable in another state. As with the related party safe harbor, the taxpayer's position is that the "subject to tax in another state" safe harbor is unambiguous and not subject to the distorted interpretation made by the Department of Taxation.

Single Sales Factor. Virginia's movement to single sales factor apportionment is slow but steady. SSF was adopted by the 2012 legislature for retailers, and the optional version of SSF for manufacturers was substantially amended to omit penalty provisions for manufacturers who fail to maintain certain employment levels. The Department of Taxation has issued draft Guidelines explaining its view of the new statute. The key issue to be resolved in final Guidelines is how to count "average employment" during the three years after the election is made. If average employment drops below 90% of the base year, the SSF election is revoked and tax benefits recaptured with interest.

Regulations. The Department of Taxation is apparently moving forward with its new policy of avoiding the issuance of regulations whenever possible. Because the procedure for adopting regulations was asserted to be too cumbersome, the Department will rely on a variety of published documents to set forth its new policies. These will include comprehensive "guideline" on a subject, "Policy Statements" as well as continued reliance on published rulings and appeals. Taxpayers will no longer be able to look just to regulations to determine the Department of Taxation's policy on any issue, and published regulations may no longer be valid in the Department's eyes. When asked the degree to which taxpayers can rely on such policy statements not published as a regulation, the Department has informally replied that for purposes of taxpayer reliance, the Department will provide the same protection as it does for taxpayers who rely on regulations. It is a curious anomaly when an informal Guideline or ruling purports to revoke a regulation.

Delayed Appeals. The Department of Taxation is running very late in handling appeals and rulings. Some appeals have been pending for over two years. Part of the problem is that record numbers of appeals and ruling requests are being filed, and the Department's staffing is down by almost 20%. The Department's Assistant Commissioner of Policy, however, indicates that the number of cases resolved annually has risen not fallen. This likely reflects that the Department is trying to resolve cases by settlements and other means that are not reflected in published numbers of the slower appeals process. **Practice tip**: In this environment, it is important that taxpayers develop careful factual records during the audit and argue those complete records carefully in the administrative appeal. Taxpayers who rely on supplementing the record later can find themselves in the position of requesting a rehearing, or worse.. **Practice tip #2:** Note in the attached chart the circadian rhythm of the Department's rulings. This reflects that during the first three months of the year, the Department's Policy staff is tied up with the General Assembly and is less able to focus on other policy issues. Do not plan on receiving any attention to your appeals or policy requests from roughly December through March.